Office of Chief Counsel
Internal Revenue Service

memorandum

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date: JUL 17 2000

to: Chief, Examination Division, Southwest District
Attn: William Kennedy, Case Manager

from: District Counsel, Southwest District, Phoenix

subject: [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Collection, Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether it is reasonable for the Service to determine that the TEFRA procedures of I.R.C. § 6621 et seq. apply to an examination of the [redacted] Form 1065 for [redacted].

CONCLUSION

It is reasonable for the Service to determine that the TEFRA procedures apply to this entity.

FACTS

In connection with the recently opened audit cycle of the [redacted], you have determined that the Service should examine a transaction included on the taxpayer's consolidated return which may involve issues of leveraged leases and component depreciation. This transaction concerns an office building owned by [redacted], which was formed in [redacted]. This partnership has two partners. The first is [redacted] ([redacted]), a subsidiary of the taxpayer. [redacted] is a [redacted]% limited partner in the partnership. The other is [redacted], a single member limited liability corporation, with [redacted] as the sole member. The LLC is the general partner, and has a [redacted] percent interest in the partnership. The partnership issued Forms K-1 for [redacted] to its two partners. The taxpayer included the amounts from these Forms K-1 on its consolidated return for [redacted], reporting the amount for the LLC as if the LLC were a division of [redacted], apparently pursuant to the provisions of Treas. Reg. § 301.7701-3(b)(1)(ii).

You wish to determine whether to follow the so-called TEFRA procedures of I.R.C. § 6221 et seq. in examining the partnership's return for [redacted], or whether such an examination may be undertaken as part of the examination of the consolidated return. For the reasons outlined below, we believe that applying the TEFRA provisions protects the Service from any later claims by the taxpayer that the Service did not follow proper procedures.

DISCUSSION

As you know, I.R.C. §§ 6621 through 6233 sets forth procedures to be followed in examinations of certain partnerships. These procedures allow a determination of certain matters at the partnership level, rendering it unnecessary to make individual determinations for each partner of the partnership. The TEFRA provisions are mandatory, and unless a partnership is excepted from such provisions (such as by being a small partner as described at § 6231(a)(1)(B)), the Service cannot make adjustments of partnership items at the partner level.

Although this system greatly simplified the examination of partnership items, allowing one examination of the partnership

rather than an "examination" of each partner, it nonetheless created hazards. Specifically, the Service bore the risk of incorrectly determining whether TEFRA procedures were required. If, for example, the Service incorrectly determined that TEFRA applied to a partnership return, statutes might run as to partners' individual returns before partner level adjustments could be made.

Fortunately, § 1232 of the Taxpayer Relief Act of 1997 provided the Service with a safety net for those instances in which it is difficult to determine whether TEFRA procedures apply. This provision added § 6231(g) to the Internal Revenue Code, which provides that if the Service, on the basis of a partnership return, reasonably determines that the TEFRA provisions apply to such return, then the TEFRA provisions apply even if the Service's determination proves to be erroneous. This section also provides that a reasonable determination that TEFRA does not apply, based on the partnership return, will be respected even if such determination proves erroneous. Thus, while we believe that every effort should be made to correctly determine whether to apply the TEFRA provisions, the Service is protected by § 6231(g) from an erroneous decision if the decision regarding whether to follow TEFRA procedures is reasonable on the basis of the partnership return.

The remaining question is thus what the Service may reasonably determine from the partnership return, i.e., whether the partnership is a TEFRA partnership. According to the plain language of I.R.C. § 6231(g)(1) and (2), the safe harbor of this section is available if the Service's determination is reasonable "on the basis of a partnership return." In other words, in making this determination, the Service should put more weight on evidence from the partnership return itself than from outside sources.

That being said, we believe that while there is no clear answer, the more reasonable approach is to examine the partnership as a TEFRA entity. I.R.C. § 6231(b) provides the exception from TEFRA treatment for small partnerships. An entity with ten or fewer partners is excepted from TEFRA procedures, so long as each partner is an individual, C corporation, or an estate of a deceased partner. In the present case, [redacted] is a C corporation, so that the only remaining question is the status of the LLC. At this point, it becomes complicated. The partnership return provides no evidence that [redacted] is the only member of the LLC. On line 4 of Schedule B of the partnership return for [redacted], the partnership indicates that it is in fact subject to the TEFRA procedures, although under Treas. Reg. § 301.6231(a)(1)-1T(b)(2), merely checking this box does not appear to constitute an

election for TEFRA to apply where it would not otherwise. From the return, therefore, the Service is faced with a partner not clearly in one of the categories of partner for small partnership treatment, and a partnership which felt at the time it filed its return that TEFRA procedures applied. While it is certainly not clear whether in fact TEFRA should apply, we believe that a reasonable determination from the partnership return is that the Service should apply §§ 6221 through 6233 in examining the partnership.

In reaching this conclusion, we acknowledge information not available from the return but subsequently discovered by the Service, from which an opposite conclusion might be reached. For example, the Service is presently aware that the LLC's sole member is [redacted], and that the LLC appears to have been disregarded as an entity on the taxpayer's consolidated return. This would be consistent with the so-called "check the box" provisions in Treas. Reg. § 301.7701-3, which allows an eligible single member LLC to be disregarded as an entity separate from its owner for federal tax purposes. At the same time, a paradox arises: if in fact [redacted] intended to elect to disregard the LLC for federal tax purposes, then treating the LLC as general partner of the partnership seems to contradict such an election. If the LLC is disregarded for federal tax purposes, then it would seem that the LLC and [redacted] cannot form an entity qualifying as a partnership for federal tax purposes, as such a partnership would effectively have only one "partner." The partnership return thus would indicate that maybe the treatment on the consolidated return was not pursuant to the "check the box" regulations, but may have been due to oversight or other reasons. A further question may be whether the LLC, because it appears to be treated as a non-entity by [redacted], is a pass-through partner of the partnership, so that the small partnership exception would not apply if in fact a valid partnership exists. See Treas. Reg. § 301.6231(a)(1)-1T(a)(2). It may therefore be that the Service has two choices in this matter, to totally disregard the partnership form, due to the inability of a single entity to form a partnership, or treat the partnership as a TEFRA entity. We believe that because of the numerous questions surrounding this issue, many of which involve the taxpayer's intent and state of mind, either conclusion would be reasonable. A decision to proceed under TEFRA, however, is based more upon factors from the partnership return, while ignoring the partnership as a separate entity would be based more upon information not on the partnership return. Because the safe harbor of I.R.C. § 6231(g) is available for reasonable determinations "on the basis of a partnership return," we believe that the safer action is to examine the partnership return under the TEFRA procedures of I.R.C. §§ 6221 through 6233.

We also acknowledge your observation that the partnership return lists [redacted] as the tax matters partner, even though [redacted] is identified on the partnership return as a limited partner. I.R.C. § 6231(a)(7) defines tax matters partner as the general partner designated as the tax matters partner, or if no general partner is so designated, the general partner having the largest profits interest in the partnership at the close of the year. It appears that as the only general partner, the LLC would be the tax matters partner as provided in this section. We understand that you are familiar with the procedural requirements where a partnership fails to properly appoint a tax matters partner. We nonetheless wish to offer our services in this regard if you desire any assistance.

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Administrative Provisions and Judicial Practice) an opportunity to comment. If you have any questions regarding the above, please contact me at (602) 207-8052.

DOREEN M. SUSI
Acting District Counsel

By: _____
JOHN W. DUNCAN
Attorney

cc: Curt Wilson, Assistant Chief Counsel
(Administrative Provisions and Judicial Practice)